

UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE

DOD BUDGET AND TRANSFORMATION

CHALLENGES AND OPPORTUNITIES

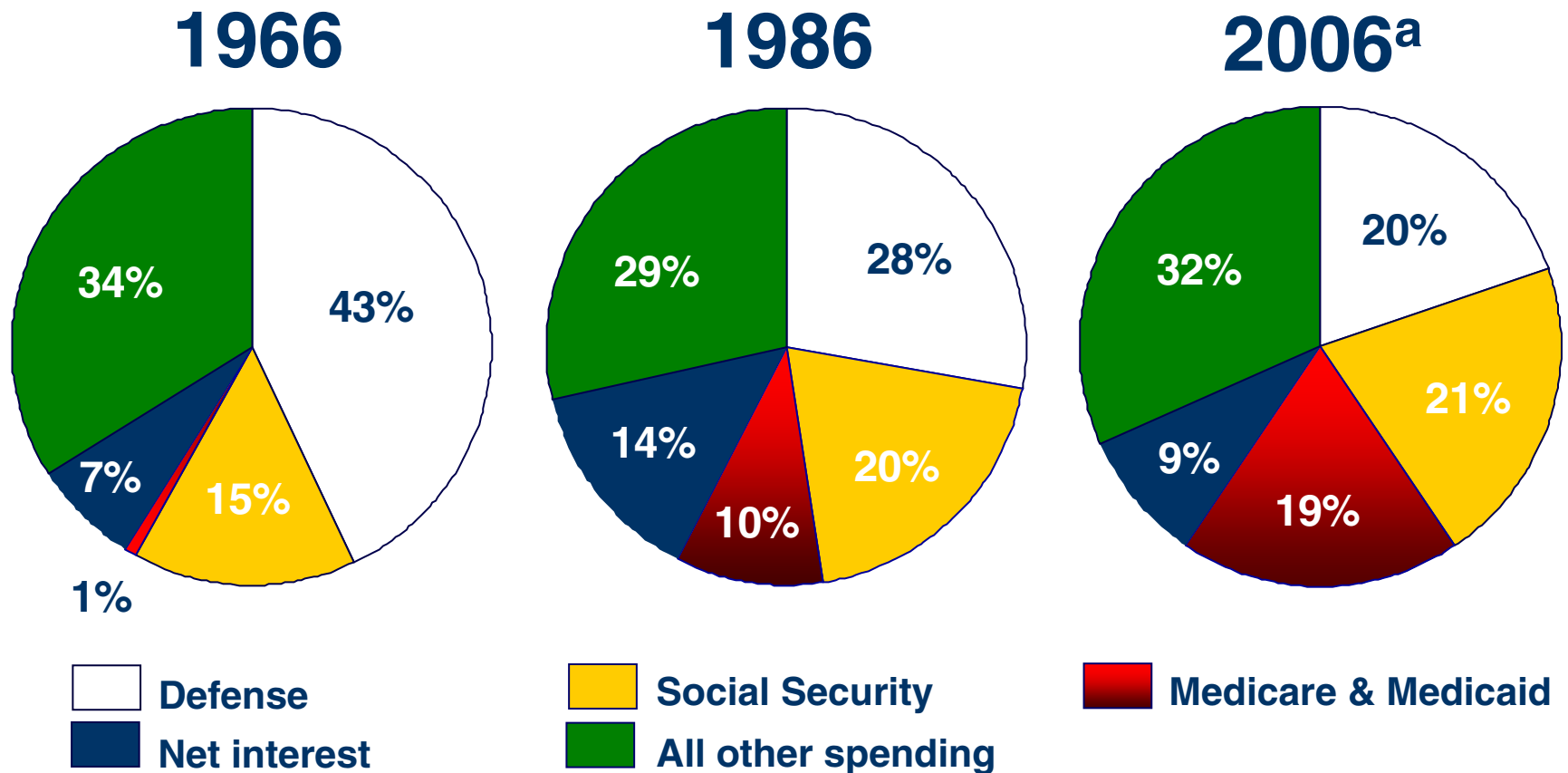
The Honorable David M. Walker
Comptroller General of the United States

**House Armed Services
Committee Briefing
January 24, 2007**



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Composition of Federal Spending

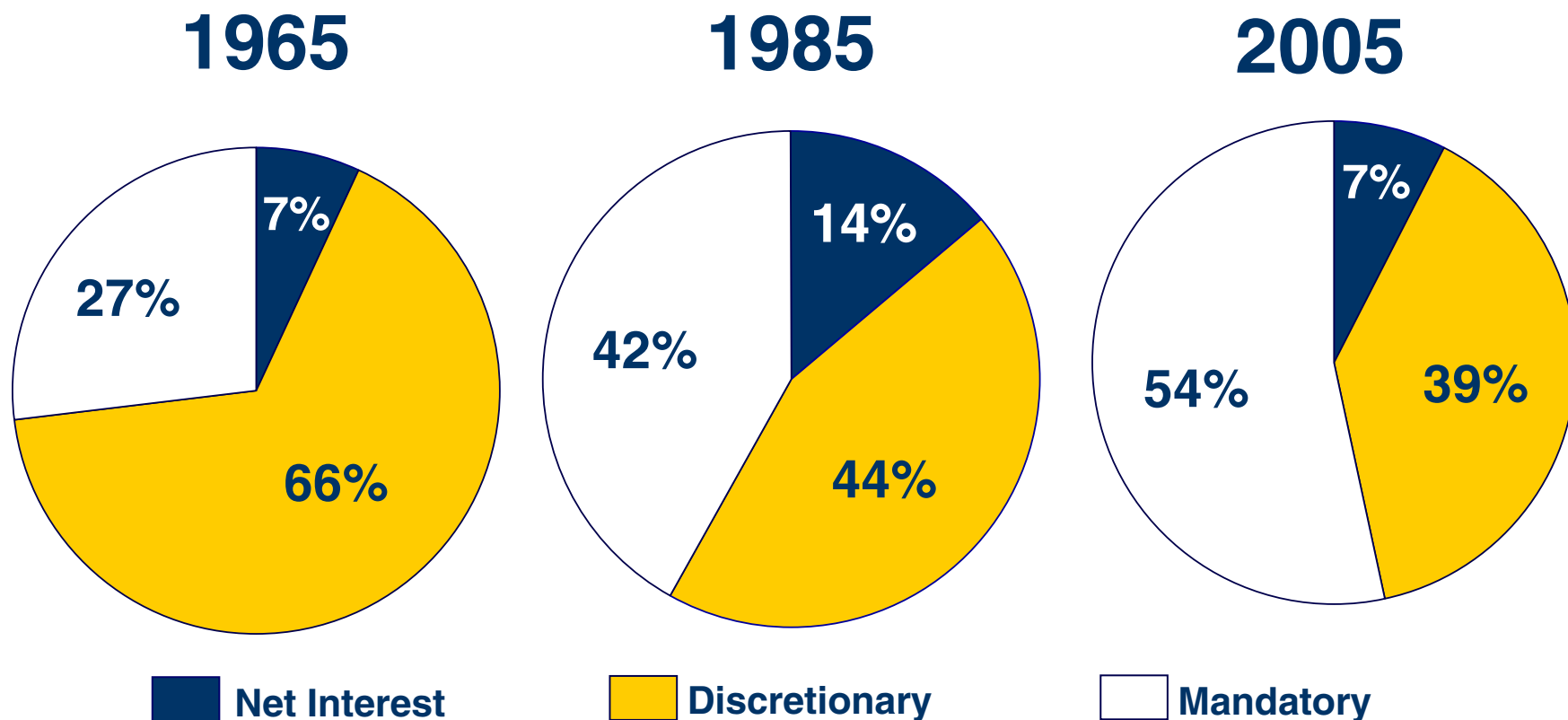


Sources: Office of Management and Budget and the Department of the Treasury.

Note: Numbers may not add to 100 percent due to rounding.

^aPreliminary.

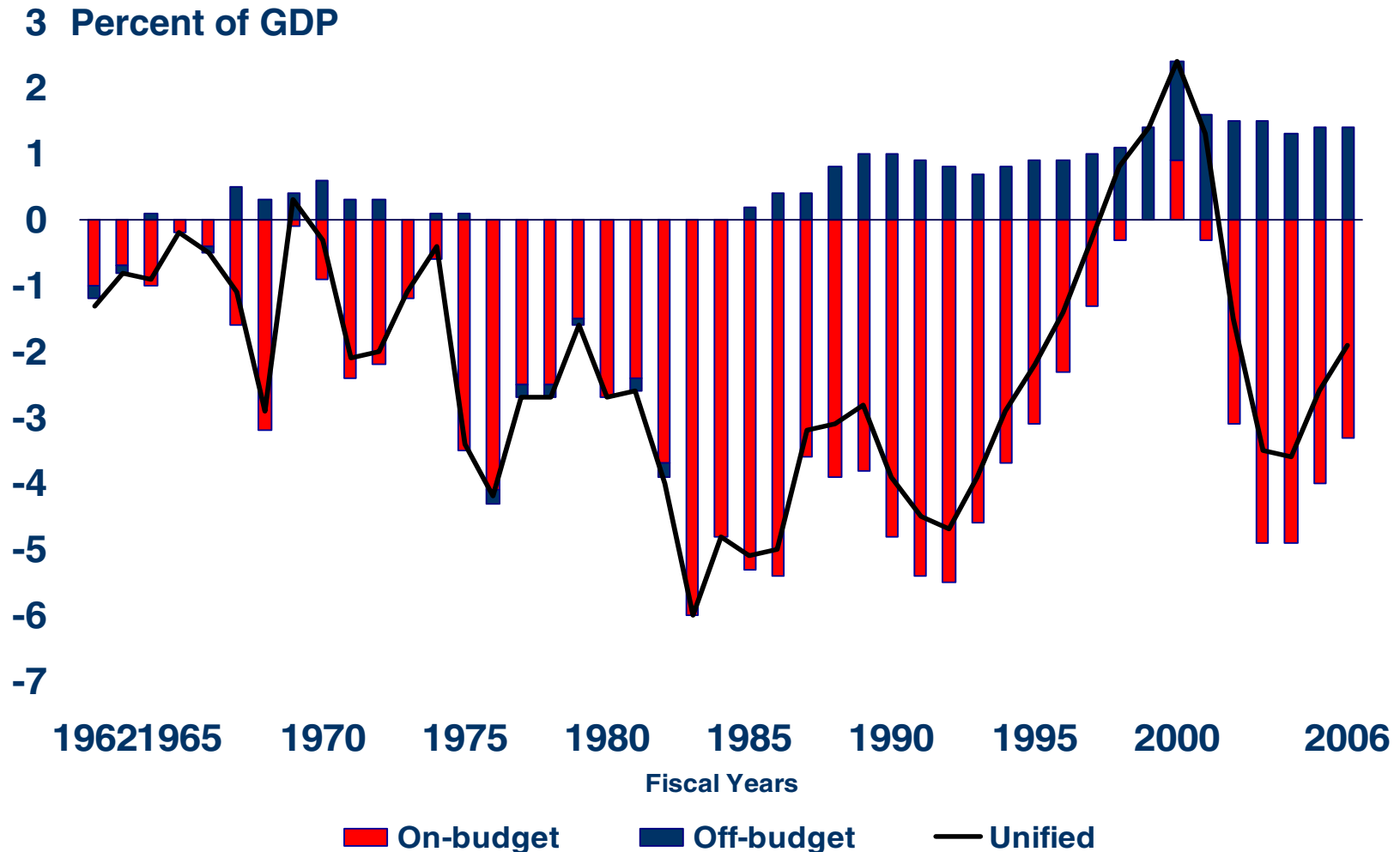
Federal Spending for Mandatory and Discretionary Programs



Source: Office of Management and Budget.

Surplus or Deficit as a Share of GDP

Fiscal Years 1962-2006



Sources: Office of Management and Budget, Department of the Treasury and the Congressional Budget Office.

Fiscal Year 2005 and 2006 Deficits and Net Operating Costs

	Fiscal Year 2005	Fiscal Year 2006
	(\$ Billion)	
On-Budget Deficit	(494)	(434)
Unified Deficit	(318)	(248)
Net Operating Cost	(760)	(450)

Sources: The Office of Management and Budget and the Department of the Treasury.

Notes: Fiscal year 2005 and 2006 net operating cost figures reflect significant but opposite changes in certain actuarial costs. For example, changes in interest rates and other assumptions used to estimate future veterans' compensation benefits increased net operating cost by \$228 billion in 2005 and reduced net operating cost by \$167 billion in 2006.

Major Reported Long-Term Fiscal Exposures (\$ trillions)

	2000	2006	% Increase
• Explicit liabilities	\$6.9	\$10.4	52
<ul style="list-style-type: none"> • Publicly held debt • Military & civilian pensions & retiree health • Other 			
• Commitments & contingencies	0.5	1.3	140
<ul style="list-style-type: none"> • E.g., PBGC, undelivered orders 			
• Implicit exposures	13.0	38.8	197
<ul style="list-style-type: none"> • Future Social Security benefits 	3.8	6.4	
<ul style="list-style-type: none"> • Future Medicare Part A benefits 	2.7	11.3	
<ul style="list-style-type: none"> • Future Medicare Part B benefits 	6.5	13.1	
<ul style="list-style-type: none"> • Future Medicare Part D benefits 	--	7.9	
Total	\$20.4	\$50.5	147

Source: 2000 and 2006 Financial Report of the United States Government.

Note: Estimates for Social Security and Medicare are at present value as of January 1 of each year and all other data are as of September 30. Totals may not add due to rounding. Percentage increases are based on actual data and may differ from increases calculated from rounded data shown in table.

Understanding the Size of Major Reported Fiscal Exposures

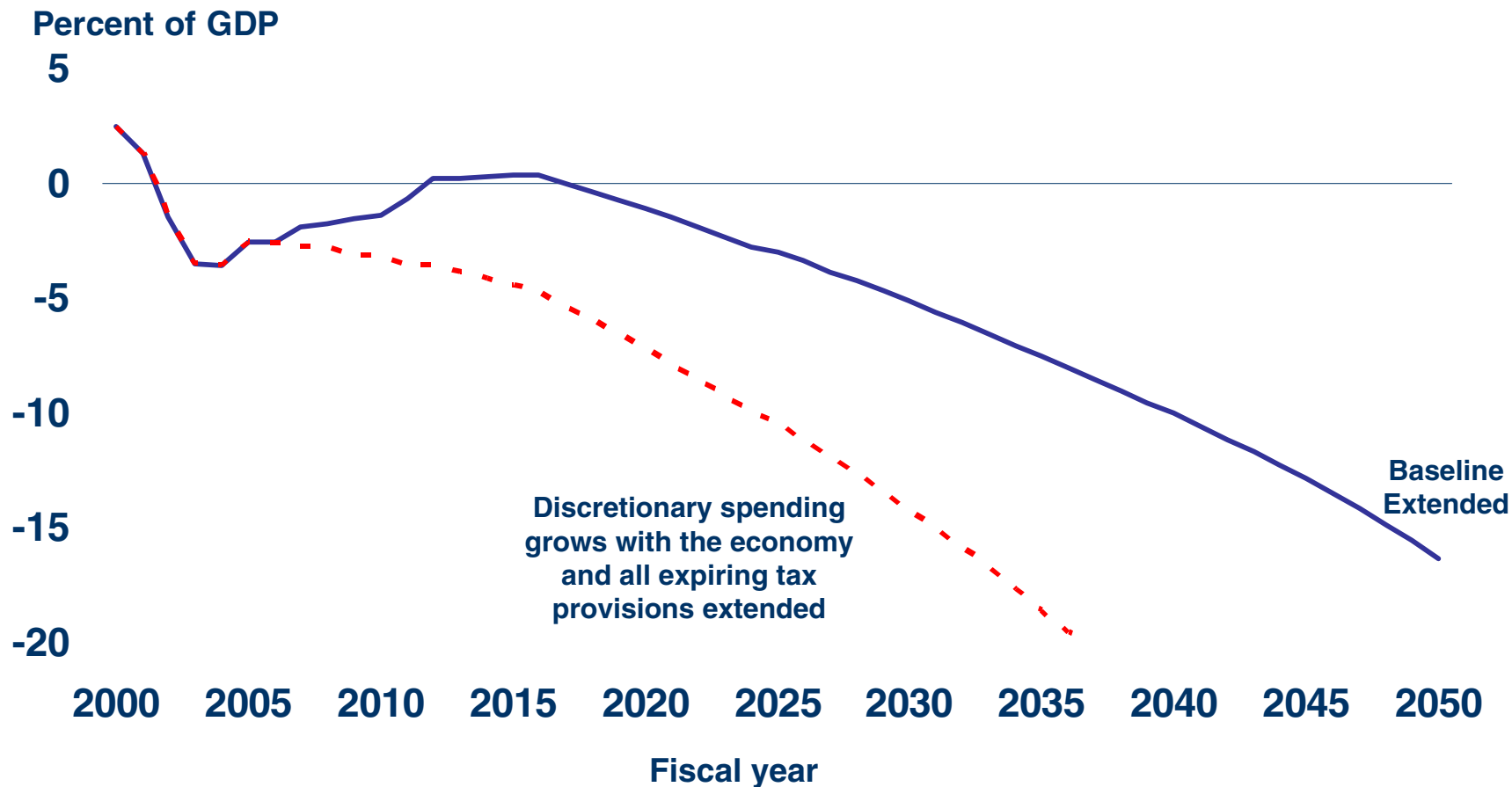
Our fiscal burden can be translated and compared as follows:

	2006
Major reported fiscal exposures	\$50.5 trillion
Total household net worth	\$53.3 trillion
Ratio of fiscal exposures to net worth	95 percent
Burden	
Per person	\$170,000
Per full-time worker	\$400,000
Per household	\$440,000
Income	
Median household income	\$46,326
Disposable personal income per capita	\$31,519
Ratio of household burden to median income	9.5

Sources: GAO analysis of data from the Department of the Treasury, Federal Reserve Board, U.S. Census Bureau and Bureau of Economic Analysis

Unified Surpluses and Deficits as a Share of GDP

Under Alternative Fiscal Policy Simulations



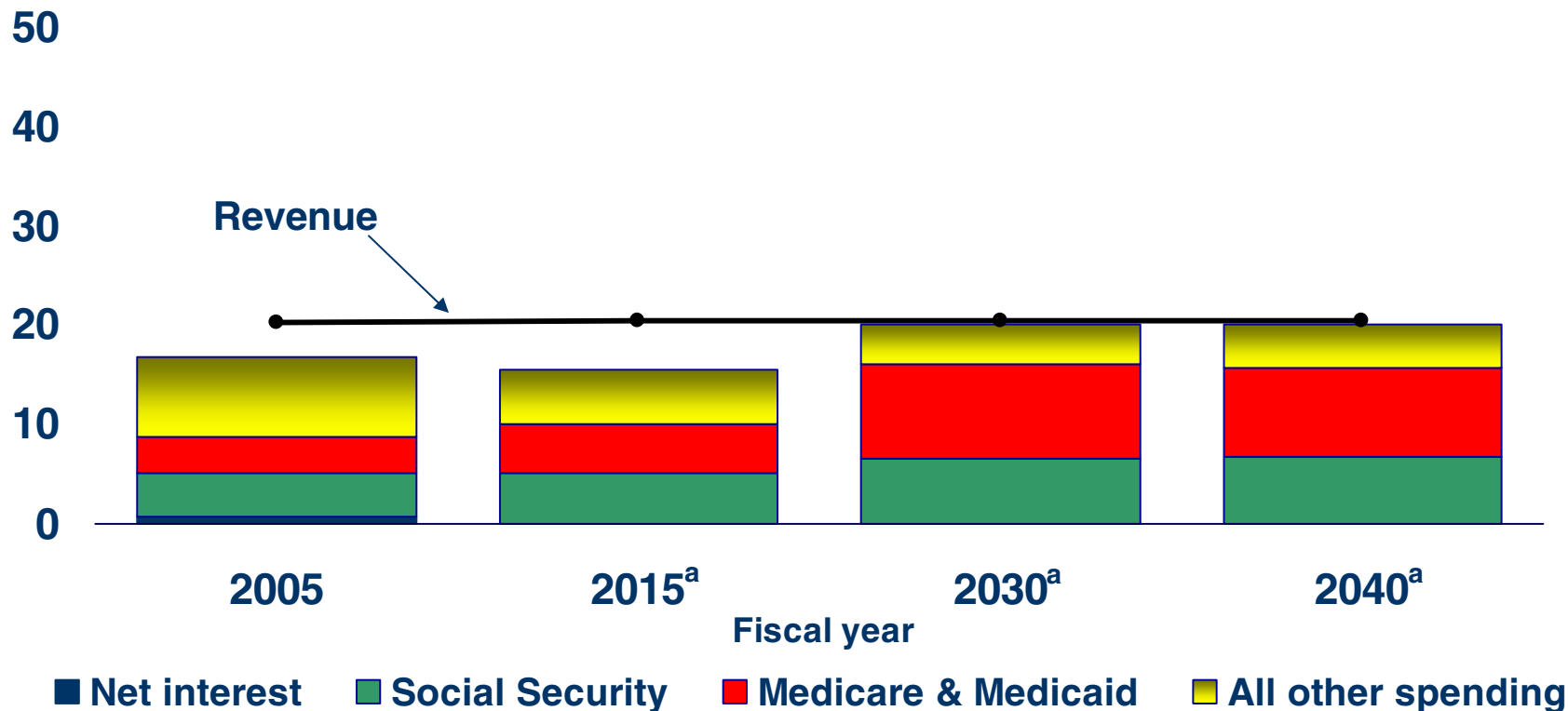
Source: GAO's January 2006 analysis.

Note: Assume currently scheduled Social Security benefits are paid in full throughout the simulation period.

Composition of Spending as a Share of GDP

Under Baseline Extended (January 2001)

Percent of GDP



Source: GAO's January 2001 analysis.

^aAll other spending is net of offsetting interest receipts.

Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions are Extended

Percent of GDP

50

40

30

20

10

0

Revenue

2005

2015

2030

2040

Fiscal year

■ Net interest

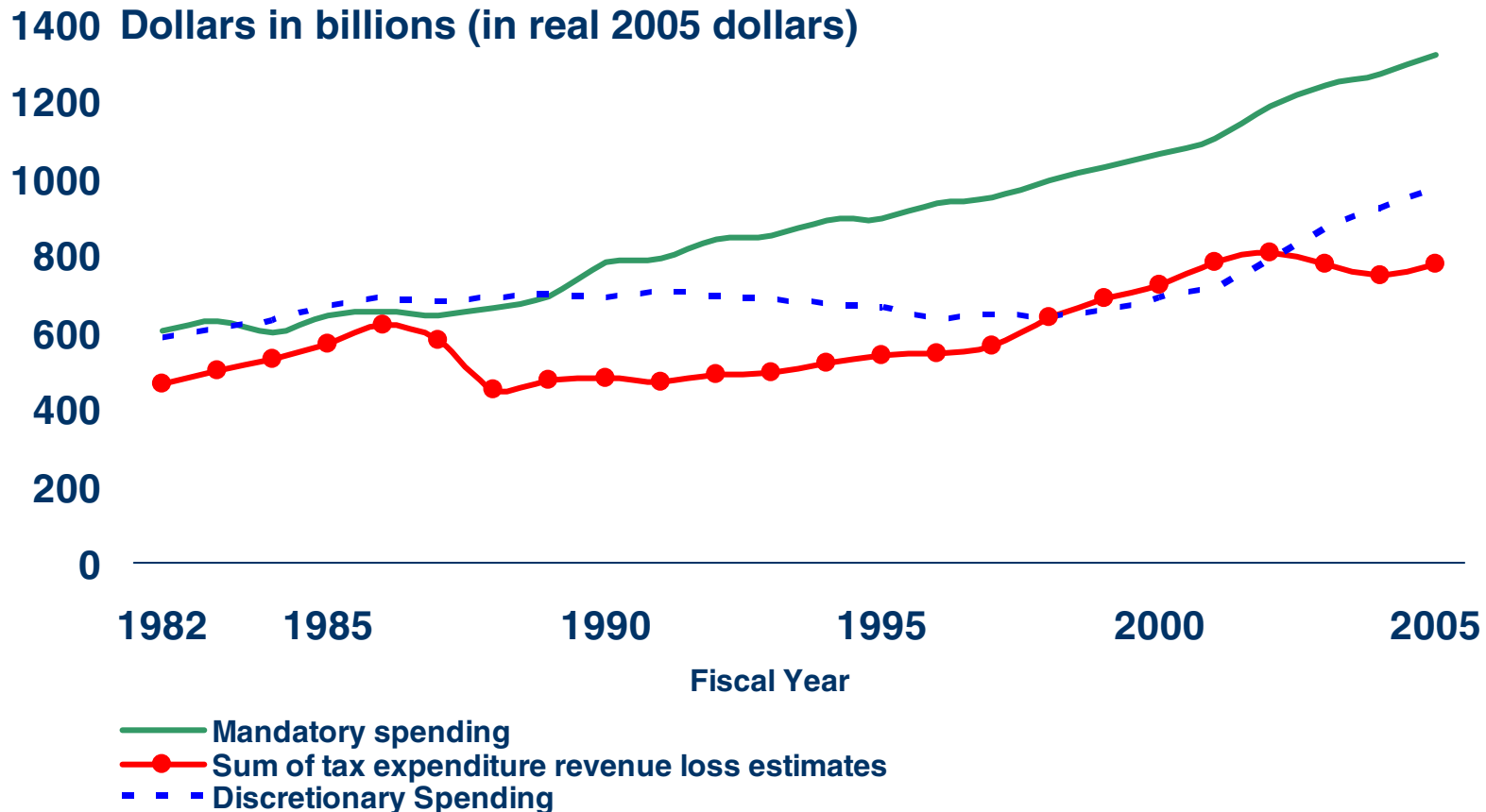
■ Social Security

■ Medicare & Medicaid

■ All other spending

Source: GAO's August 2006 analysis.

Federal Tax Expenditures Exceeded Discretionary Spending for Half of the Last Decade



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2007.

Note: Summing tax expenditure estimates does not take into account interactions between individual provisions. Outlays associated with refundable tax credits are included in mandatory spending.

Current Fiscal Policy Is Unsustainable

- **The “Status Quo” is Not an Option**

- We face large and growing structural deficits largely due to known demographic trends and rising health care costs.
- GAO’s simulations show that balancing the budget in 2040 could require actions as large as
 - Cutting total federal spending by 60 percent or
 - Raising federal taxes to 2 times today's level

- **Faster Economic Growth Can Help, but It Cannot Solve the Problem**

- Closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years.
- During the 1990s, the economy grew at an average 3.2 percent per year.
- As a result, we cannot simply grow our way out of this problem. Tough choices will be required.

The Way Forward: A Three-Pronged Approach

1. Improve Financial Reporting, Public Education, and Performance Metrics
2. Strengthen Budget and Legislative Processes and Controls
3. Fundamental Reexamination & Transformation for the 21st Century (i.e., entitlement programs, other spending, and tax policy)

*Solutions Require Active Involvement from
both the Executive and Legislative Branches*

The Way Forward

Improve Financial Reporting, Public Education, and Performance Metrics

- Improve transparency & completeness of President's budget proposal:
 - Return to 10-year estimates in budget both for current policies and programs and for policy proposals
 - Include in the budget estimates of long-term cost of policy proposals & impact on total fiscal exposures.
 - Improve transparency of tax expenditures
- Consider requiring President's budget to specify & explain a fiscal goal and a path to that goal within 10-year window—or justify an alternative deadline
- Require annual OMB report on existing fiscal exposures [liabilities, obligations, explicit & implied commitments]
- Require enhanced financial statement presentation and preparation of summary annual report that is both useful and used
- Increase information on long-range fiscal sustainability issues in Congressional Budget Resolution & Budget Process.
- Develop key national (outcome-based) indicators (e.g. economic, security, social, environmental) to chart the nation's posture, progress, and position relative to the other major industrial countries

The Way Forward:

Strengthen Budget and Legislative Processes and Controls

- Restore discretionary spending caps & PAYGO rules on both spending and tax sides of the ledger
- Develop mandatory spending triggers [with specific defaults], and other action-forcing provisions (e.g., sunsets) for both direct spending programs and tax preferences
- Develop, impose & enforce modified rules for selected items (e.g., earmarks, emergency designations, and use of supplementals)
- Require long-term cost estimates (e.g. present value) for any legislative debate on all major tax and spending bills, including entitlement programs. Cost estimates should usually assume no sunset
- Extend accrual budgeting to insurance & federal employee pensions; develop techniques for extending to retiree health & environmental liabilities
- Consider biennial budgeting
- Consider expedited line item rescissions from the President that would only require a majority vote to override the proposed rescission(s)

The Way Forward: Fundamental Reexamination & Transformation

- Restructure existing entitlement programs
- Reexamine and restructure the base of all other spending
- Review & revise existing tax policy, including tax preferences and enforcement programs
- Expand scrutiny of all proposed new programs, policies, or activities
- Reengineer internal agency structures and processes, including more emphasis on long-term planning, integrating federal activities, and partnering with others both domestically and internationally
- Strengthen and systematize congressional oversight processes
- Increase transparency associated with government contracts and other selected items
- Consider a capable, credible, bi-partisan entitlement and tax reform commission along the lines proposed by Sen. Voinovich and Cong. Wolf

GAO's High-Risk List 2006

High-Risk Areas

Designated High Risk

Addressing Challenges in Broad-based Transformations

Protecting the Federal Government's Information Systems and the Nation's Critical Infrastructures	1997
Strategic Human Capital Management ^a	2001
U.S. Postal Service Transformation Efforts and Long-Term Outlook ^a	2001
Managing Federal Real Property ^a	2003
Implementing and Transforming the Department of Homeland Security	2003
Establishing Appropriate and Effective Information-Sharing Mechanisms to Improve Homeland Security	2005
DOD Approach to Business Transformation^a	2005
DOD Supply Chain Management (formerly Inventory Management)	1990
DOD Weapon Systems Acquisition	1990
DOD Business Systems Modernization	1995
DOD Financial Management	1995
DOD Support Infrastructure Management	1997
DOD Personnel Security Clearance Program	2005

Managing Federal Contracting More Effectively

DOE Contract Management	1990
NASA Contract Management	1990
DOD Contract Management	1992
Management of Interagency Contracting	2005

Assessing the Efficiency and Effectiveness of Tax Law Administration

Enforcement of Tax Laws ^{a, b}	1990
IRS Business Systems Modernization ^c	1995

Modernizing and Safeguarding Insurance and Benefit Programs

Medicare Program ^a	1990
HUD Single-Family Mortgage Insurance and Rental Housing Assistance Programs	1994
Medicaid Program ^a	2003
Modernizing Federal Disability Programs ^a	2003
Pension Benefit Guaranty Corporation Single-Employer Insurance Program ^a	2003

National Flood Insurance Program

2006

Other

FAA Air Traffic Control Modernization	1995
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^a Legislation is likely to be necessary, as a supplement to actions by the executive branch, in order to effectively address this high-risk area.

^b Two high-risk areas—Collection of Unpaid Taxes and Earned Income Credit Noncompliance—have been consolidated to make this area.

^c The IRS Financial Management high-risk area has been incorporated into this high-risk area.

Suggested DOD Related Oversight Areas for the 110th Congress

- Address acquisition and contracting issues.
- Transform business operations, including addressing all related “High Risk” areas.
- Enhance information sharing, accelerate transformation, and improve oversight related to the Nation’s intelligence agencies.
- Strengthen efforts to prevent proliferation of nuclear, chemical, and biological weapons and their delivery systems (missiles).
- Ensure a successful transformation of the nuclear weapons complex.
- Review U.S. and Coalition efforts to stabilize and rebuild Iraq and Afghanistan, including how these efforts are to be funded.
- Assess overall military readiness, transformation efforts, and existing plans to assure the sustainability of the All-Volunteer Force.

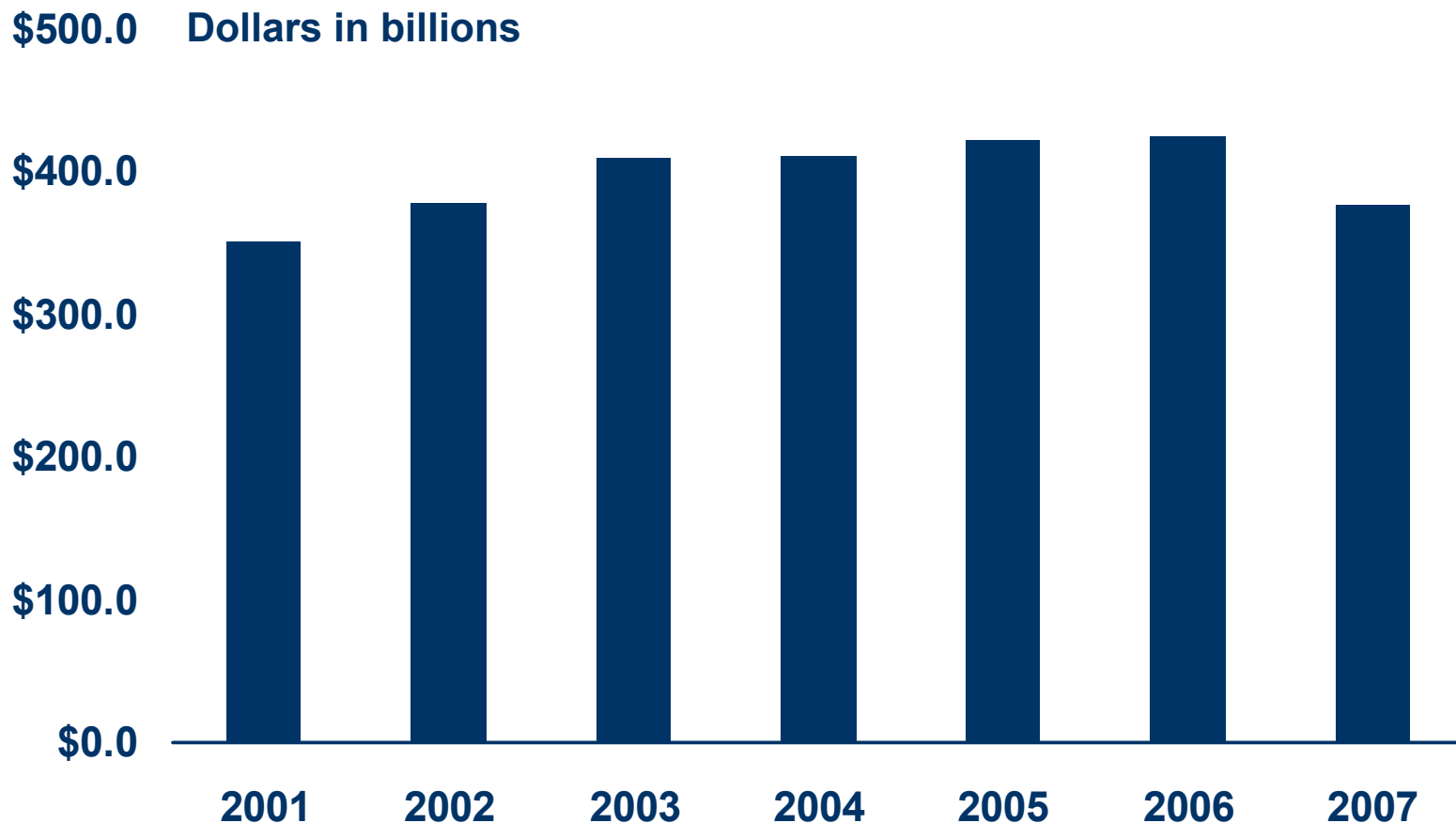
Note: From November 17, 2006 letter to the 110th Congress (GAO-07-235R).

DOD Faces the Challenge of Balancing Near Term and Long Term Wants, Needs, and Affordability

- In FY 2007 constant dollars, DOD's regular budget has grown from about \$351 billion in FY 2001 to about \$425 billion in FY 2006. To date, DOD's FY 2007 regular budget is funded at about \$378 billion, with decisions on additional funding for military construction and other programs still pending. Supplemental funding for the Global War on Terrorism (GWOT) has added hundreds of billions of dollars to DOD's available budgetary resources.
- Near term, DOD is paying for the GWOT and facing challenges in maintaining readiness.
- Long term, DOD must address military pay and benefits and weapons modernization and force transformation, which may not be affordable or sustainable.
- DOD's efforts to transform its business systems and processes will take many years to achieve, but could free up resources through efficiencies and reduction in waste.

DOD's Regular Budget Growth (Excluding GWOT)

DOD Regular Appropriation FY 2001-2007

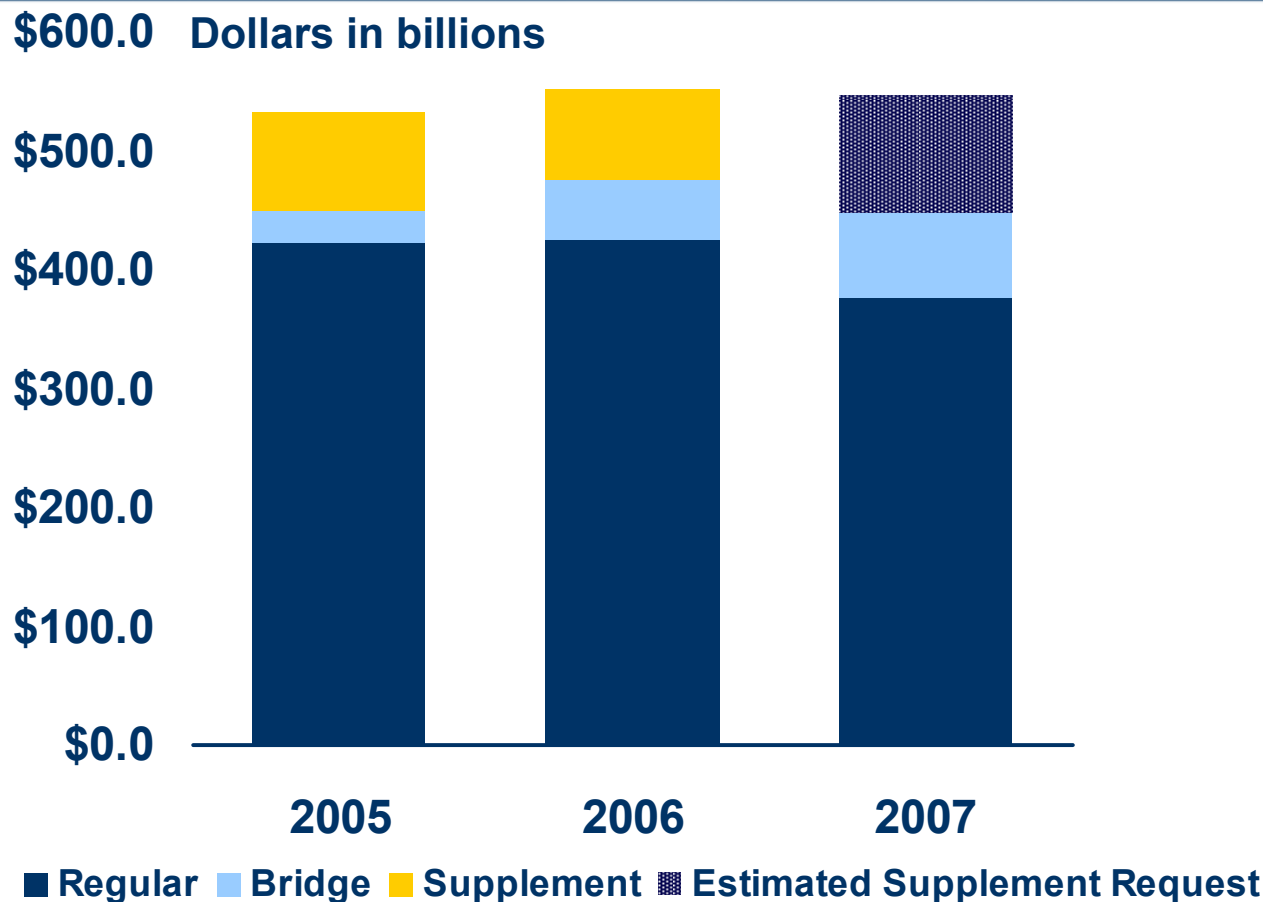


Source: GAO analysis of Congressional Research Service data.

Note: The FY 2007 figure does not include funding for military construction and other programs, which is being considered in a single appropriations bill that has not yet been passed. All amounts are in constant 2007 dollars.

Total Budgetary Resources Provided to DOD

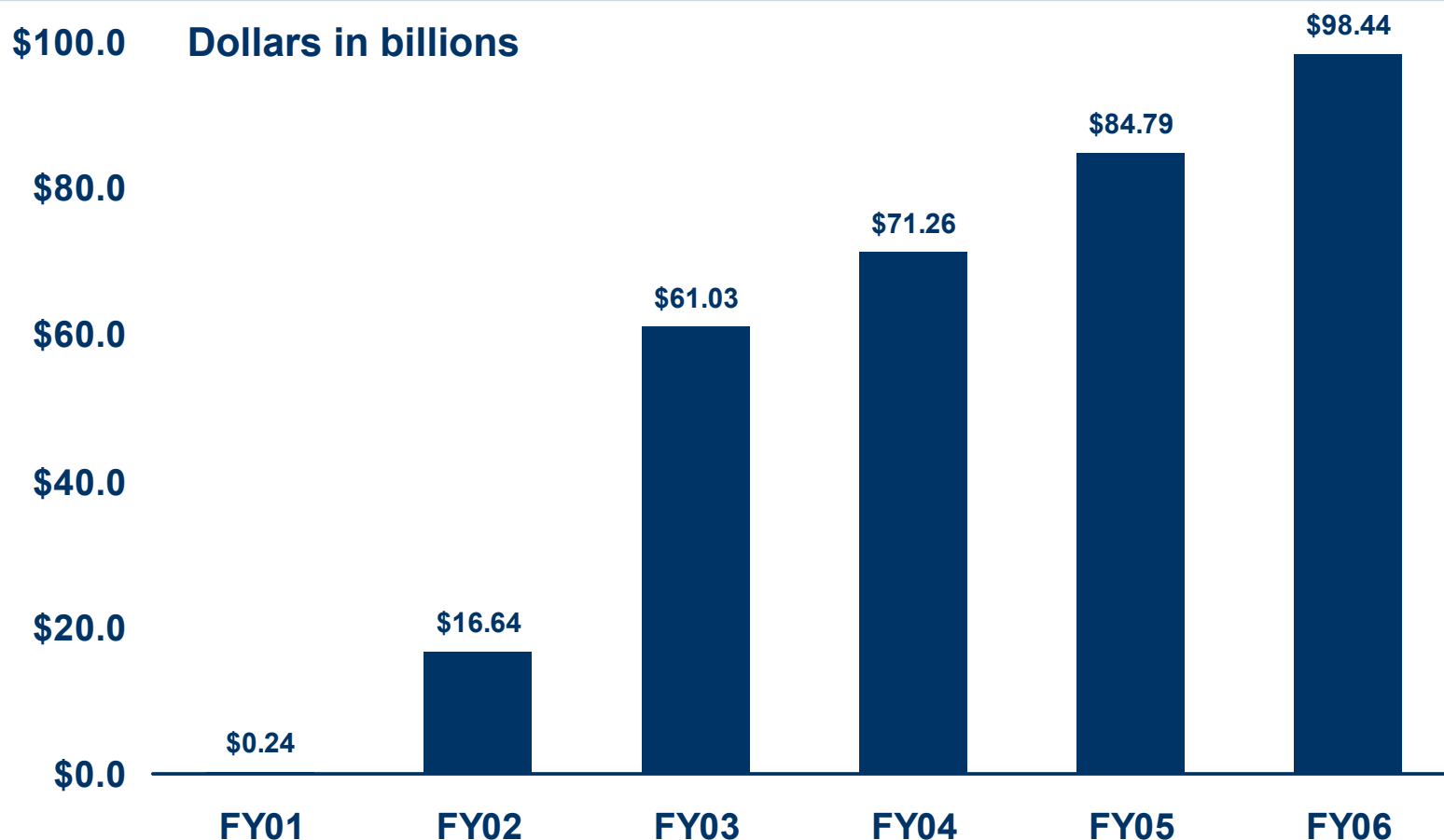
Total Defense Resources FY 2001-2007 (as of January 2007)



Source: GAO analysis of Congressional Research Service data.

Notes: Bridge, or Title IX, is the section of DOD's regular defense appropriation that outlines emergency spending provisions for operations in support of GWOT. The figure shown for the FY 2007 regular appropriation does not include funding for military construction and other programs, which is being considered in a single appropriations bill that has not yet been passed. DOD's FY 2007 supplemental request, not yet submitted, has been estimated at about \$100 billion. All amounts are in constant 2007 dollars.

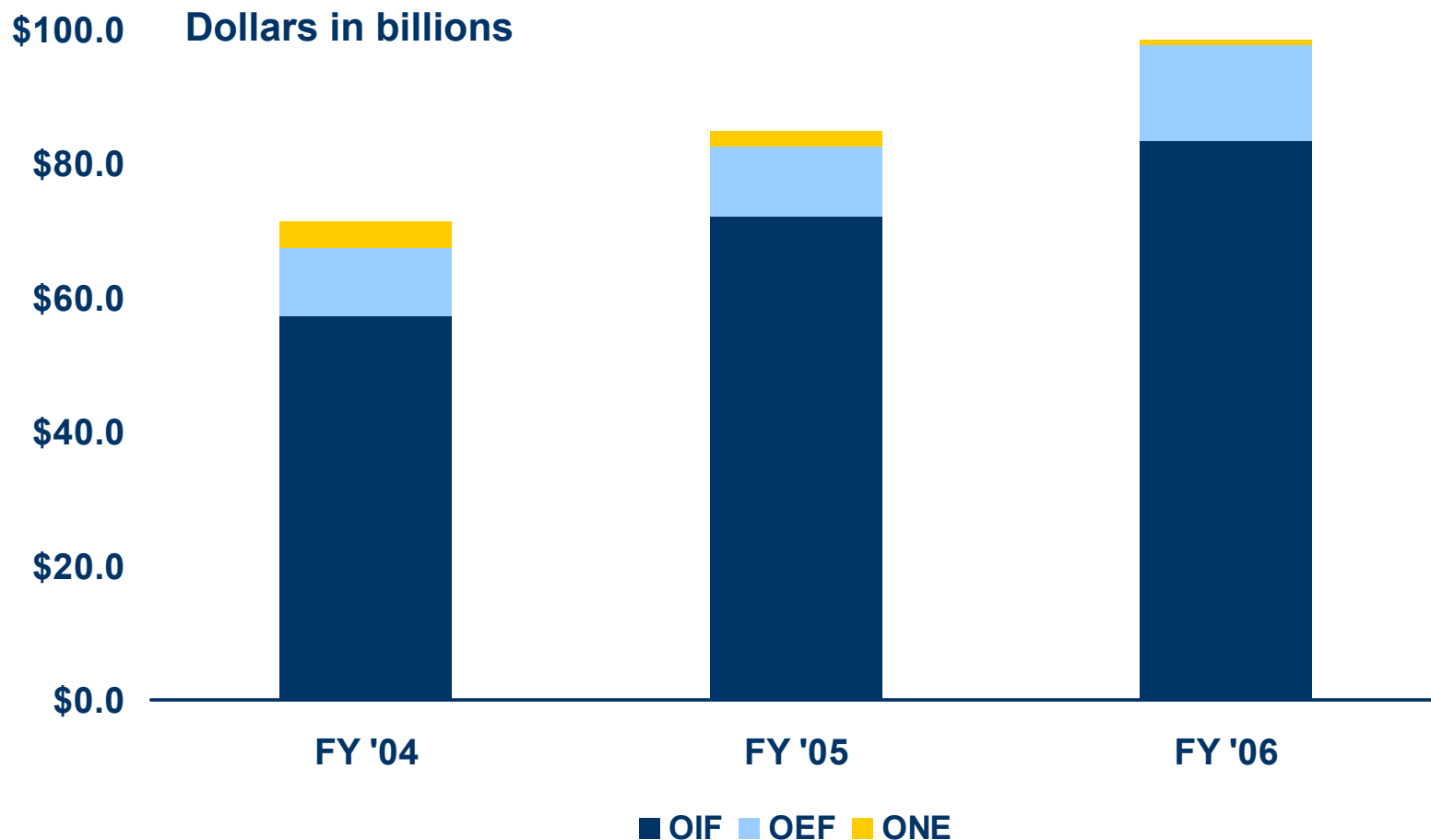
DOD's Reported GWOT Obligations for FY 2001 thru FY 2006



Source: GAO analysis of DOD data.

Notes: Reported GWOT obligations include Operation Noble Eagle, Operation Enduring Freedom, and Operation Iraqi Freedom. Figures do not include about \$17.9 billion obligated in FY 2001-2003 that DOD did not include in its cost reports, or any obligations for classified activities. GAO has assessed the reliability of DOD's obligation data and found significant problems, such that they may not accurately reflect the true dollar value of GWOT obligations.

DOD's Reported GWOT Obligations by Operation for FYs 2004, 2005, 2006



Source: GAO.

Note: GAO has assessed the reliability of DOD's obligation data and found significant problems, such that they may not accurately reflect the true dollar value of GWOT obligations.

Increased Budget Transparency Needed

- Based on recent DOD guidance, the rules governing what can be included in the FY 2007 supplemental funding request have been expanded to include items not strictly limited to ongoing operations, but to overall efforts related to the larger war on terror.
- The lines between what is being funded through regular and supplemental appropriations are becoming increasingly blurred, making it difficult for decision makers to understand and balance DOD's wants, needs, and affordability.
- To provide greater transparency over its budget, DOD should consider moving certain GWOT costs into its regular budget to assist decision makers in weighing priorities and trade-offs when making financial decisions.
- DOD needs to take stronger actions to control GWOT costs by setting general parameters to guide commanders' and services' cost control efforts.
- GAO has found significant reliability problems with the GWOT cost data, which impedes the ability of Congress and others to make informed decisions about GWOT costs and related funding needs.

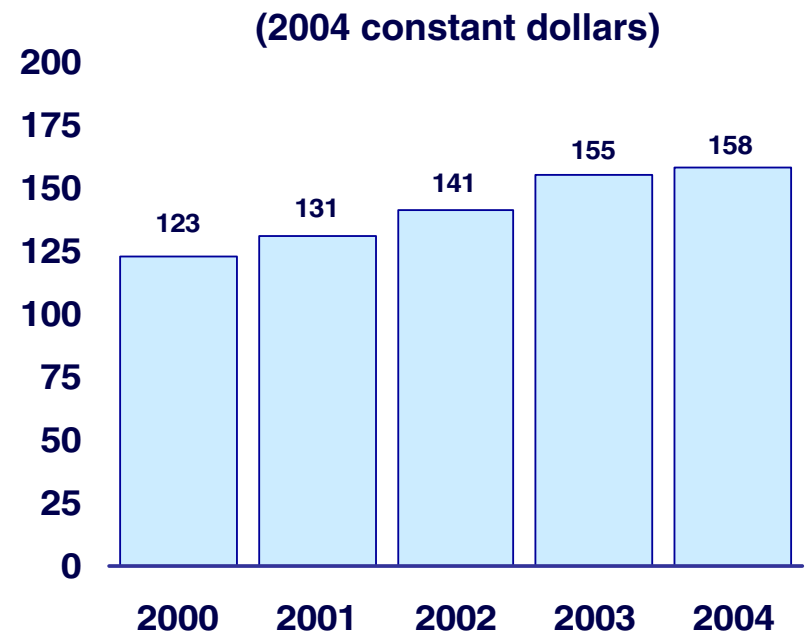
Balancing Wants, Needs and Affordability: Maintaining Near Term Readiness

- Readiness is being measured against two different standards 1) the traditional war time missions that units are expected to undertake based on their structure, and 2) their currently directed missions—primarily, supporting operations in Iraq and Afghanistan.
- Although there are some concerns with deployed units, the deployed units are in better shape to undertake the currently directed missions than non-deployed units because they receive priority for personnel and equipment.
- When measured against traditional war time missions, there are readiness concerns (equipment, personnel, and training) for both deployed and non-deployed units

Balancing Wants, Needs and Affordability: Reexamining Active Duty Personnel Pay and Benefits

- The cost of active duty pay and benefits was \$158 billion in fiscal year 2004 and growing.
- Enhanced pay and benefits, including health care costs, increased costs to an average of \$111,783 per person.
- DOD needs to assess the affordability and sustainability of the compensation system and the reasonableness and appropriateness of the allocation to cash and benefits and whether changes could more efficiently achieve recruiting and retention goals.

Total Compensation Costs for Fiscal Years 2000-2004



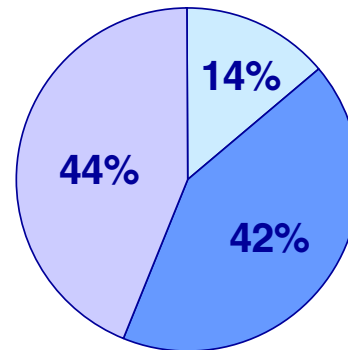
Source: GAO-05-798.

Notes: Our calculations include supplemental funding for the Global War on Terrorism. Since fiscal year 2002 over 100,000 mobilized reservists were paid out of the cash compensation. If you considered these personnel, the average costs to provide compensation would be about \$5,000 per capita lower.

Balancing Wants, Needs and Affordability: Reexamining Health Care Benefits

- The cost of TRICARE more than doubled from FY01 to FY05.
- Costs have grown due to increases in enrollment, benefits, medical inflation, and GWOT.
- TRICARE does not fully utilize market incentives to shape utilization.
- TRICARE has low enrollment fees, deductibles, and other beneficiary expenses compared to other plans.

TRICARE Beneficiaries in Fiscal Year 2005

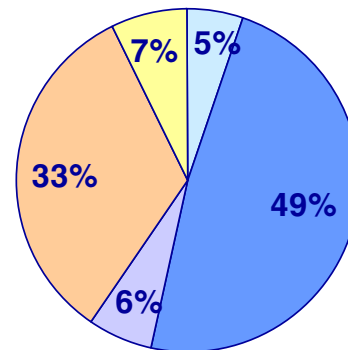


14%: TRICARE for Life retirees and dependents (generally age 65 and older)

42%: Active duty personnel and dependents

44%: Retirees and dependents (generally under age 65)

DOD Estimates of Factors Contributing to Increases in DOD's Health Care Costs, 2001-2005



5%: Other Congressionally-Mandated Benefit Changes

49%: TRICARE for Life

6%: GWOT

33%: Medical Inflation

7%: Increase in Retirees and Dependents Under 65

Source: GAO-07-48 (top pie),
GAO analysis of DOD data (bottom pie).

Balancing Wants, Needs and Affordability: Funding Weapons Modernization and Force Transformation

- From fiscal years 2001 to 2006, DOD has doubled its planned investments in new systems from about \$700 billion to nearly \$1.4 trillion, but this has not produced more stability or better outcomes.
- DOD is also restructuring forces to execute operations in the new security environment more effectively. This includes such efforts as Army modularity, which has grown in cost from an estimated \$28 billion in 2004 to \$52.5 billion as of April 2006.

DOD Continues to Confront Pervasive, Longstanding Management Problems Related to Its Business Operations

- **Management weaknesses cut across all of DOD's major business areas, and its approach to business transformation was designated as high risk in 2005.**
- **Examples of longstanding issues include:**
 - Supply chain management has been designated high risk since 1990
 - Weapons System Acquisition was also designated high risk in 1990
 - Financial Management has been designated as high-risk since 1995

Systemic Defense Acquisition Challenges

1. **Service budgets are allocated largely according to top line historical percentages rather than Defense-wide strategic assessments and current and likely resource limitations.**
2. **Capabilities and requirements are based primarily on individual service wants versus collective Defense needs** (i.e. based on current and expected future threats) that are both affordable and sustainable over time.
3. **Defense consistently over-promises and under-delivers in connection with major weapons, information, and other systems** (i.e. capabilities, costs, quantities, schedule).
4. **Defense often employs a “plug and pray approach” when costs escalate** (i.e. divide total funding dollars by cost per copy, plug the number that can be purchased, then pray that Congress will provide more funding to buy more quantities).
5. **Congress sometimes forces the department to buy items** (e.g. weapons systems) **and provide services** (e.g. additional health care for non-actives) **that the department does not want and we cannot afford.**

Systemic Defense Acquisition Challenges (cont'd)

6. **DOD tries to develop high risk technologies after programs start instead of setting up funding, organizations, and processes to conduct high risk technology development activities in low cost environments (i.e. technology development is not separated from product development). Program decisions to move into design and production are made without adequate standards or knowledge.**
7. **Program requirements are often set at unrealistic levels, then changed frequently as recognition sets in that they cannot be achieved.** As a result, too much time passes, threats may change, and/or members of the user and acquisition communities may simply change their mind. The resulting program instability causes cost escalation, schedule delays, fewer quantities and reduced contractor accountability.
8. **Contracts, especially service contracts, often do not have definitive or realistic requirements at the outset in order to control costs and facilitate accountability.**
9. **Contracts typically do not accurately reflect the complexity of projects nor appropriately allocate risk between the contractors and the taxpayers (e.g. cost plus, cancellation charges)**

Systemic Defense Acquisition Challenges (cont'd)

- 10. Key program staff rotate too frequently thus promoting myopia and reducing accountability (i.e. tours based on time versus key milestones). Additionally, the revolving door between industry and the Department presents potential conflicts of interest.**
- 11. The acquisition workforce faces serious challenges (e.g. size, skills, knowledge, succession planning).**
- 12. Incentive and award fees are often paid based on contractor attitudes and efforts versus positive results (i.e. cost, quality, schedule).**
- 13. Inadequate oversight is being conducted by both the Defense Department and the Congress which results in little to no accountability for recurring and systemic problems.**
- 14. Some individual program and funding decisions made within the Department and by the Congress serve to undercut sound policies.**
- 15. Lack of a professional, term-based CMO at DOD serves to slow progress on defense transformation and reduce the chance of success in the acquisitions/contracting and other key business areas.**

Selected Potential DOD Transformation Related Actions

- Revise the current approach to developing national military strategy (e.g., order, integration)
- Take a longer range, and more enterprise-wide approach to program planning and budget integration (e.g., life cycles, opportunity costs)
- Employ a more strategic and integrated approach to business information system efforts and financial audit initiatives
- Differentiate between war fighting and business systems development, implementation, and maintenance (e.g., resource control, project approval)
- Focus on achieving real success in connection with financial management efforts (e.g., systems, controls, information, compliance and opinions)
- Employ a total force management approach to planning and execution (e.g., military, civilian, contractors)

Selected Potential DOD Transformation Related Actions (cont'd)

- Get the design and implementation of the NSPS right, including modernizing and integrating the DOD, Service, domain, unit, and individual performance measurement and reward systems
- Revise the process for developing and communicating key changes (e.g., DOD transformation, NSPS)
- Reduce the number of layers, silos, and footprints
- Recognize the difference between approving and informing
- Review and revise current military compensation policies and practices (e.g., more targeted and market-based)
- Strengthen emphasis on horizontal and external activities (e.g., partnerships)
- Create a Chief Management Officer to drive the business transformation process

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The Honorable David M. Walker
Comptroller General of the United States

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Contact

Paul Anderson, Managing Director, Public Affairs
AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office
441 G Street NW, Room 7149
Washington, D.C. 20548

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